SUPREME COURT, U. S.

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No. 127

In the Supreme Court of the United States

OCTOBER TERM, 1967

READING COMPANY, PETITIONER

v.

FRANCIS SHUNK BROWN, 3RD, TRUSTEE OF THE ESTATE OF I. J. KNIGHT REALTY CORP., BANKRUPT, AND UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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On November 16, 1962, the I. J. Knight Realty Corporation petitioned for an arrangement under Chapter XI of the Bankruptcy Act. On that day the district court appointed a receiver and authorized him to operate Knight's business of leasing space in the Fretz Building in Philadelphia, Knight's principal asset, and to operate the building for the benefit of its tenants. (Pet. 12; R. 22a.)[1]

[1] "R." references are to the appendix to the brief filed by the appellant in the court of appeals.

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On January 1, 1963, the Fretz Building was completely destroyed by a fire that spread to adjoining premises, thus damaging petitioner's property (Pet. 12; R. 22a). On April 3, 1963, petitioner filed a claim in the arrangement for its fire losses, asserting them to be "administrative expenses due to the negligence of the Receiver" in operating the debtor's business. Thereafter, 146 others in the same position as petitioner claimed more than $3,500,000 on the same theory.[2] (Pet. 12; R. 22a–23a.) On May 14, 1963, the debtor was voluntarily adjudicated a bankrupt and a trustee in bankruptcy was elected (R. 20a).

Other claims against the estate—which arose before filing of the arrangement petition—total about $625,000, including federal tax claims of $245,000. Depending on the outcome of the trustee's litigation against Knight's fire insurers, the estate's assets will be between $630,000 and $845,000. (Pet. 13; R. 23a.)

Thus the issue here is whether, as petitioner claims, its damages resulting from the fire may be claimed as "administrative" expenses of the arrangement. If so, then it and the like claims have first priority to payment "in full," and "administrative" expenses will consume the entire estate. If not, the claims of the other statutory priority creditors, including the claim of the United States for taxes, will be satisfied out of funds remaining after the payment of secured claims and the costs of administration.

The trustee in bankruptcy moved to expunge petitioner's claim on the ground that it was not an ad-

[2] The instant case is a test case for all 147 of the claims. (R. 18a–19a, 21a, 23a, 36a–37a.)

ministrative expense (R. 16a).[3] The referee granted the motion (R. 22a–33a). The district court affirmed (R. 35a–48a). The Court of Appeals for the Third Circuit, by a four-to-three decision on rehearing *en banc*,[4] affirmed the district court's holding that the tort claim was not a cost of administering the estate, and was therefore not entitled to a first priority which Section 64a(1) of the Bankruptcy Act, 11 U.S.C. 104(a)(1), gives to administrative expenses. (Pet. 11–22).

The decision of the court of appeals is correct. There is no conflict of decisions, and no occasion for review in this Court.

1. In an ordinary bankruptcy, priorities of unsecured creditors' claims are created and governed solely by Section 64a of the Bankruptcy Act, 11 U.S.C. 104(a). Congress has provided that the same priorities should apply in a Chapter XI proceeding. Bankruptcy Act 302, 11 U.S.C. 702; *American A. & B. Coal Corp.* v. *Leonardo Arrivabene, S. A.*, 280 F. 2d 119, 124 (C.A. 2).

Section 64a(1), 11 U.S.C. 104(a)(1), gives first priority to the "actual and necessary costs and expenses of preserving the estate * * *." When, as in a Chapter XI proceeding, a trustee continues to operate the debtor's business, the courts have allowed such a

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[3] Solely for the purpose of motion to expunge, the trustee conceded that his negligence—imputed from the acts of a plumber he had hired—caused the fire (R. 36a, n. 1).

[4] The appeal was first argued to a three-judge division, but, before decision, the court of appeals *sua sponte* ordered a rehearing before the full court.

first priority to amounts owed suppliers, employees, and others who deal with the estate after the filing of the petition. *White* v. *Murtha*, 343 F. 2d 831 (C.A. 5); *In Re Capital Service*, 136 F. Supp. 430 (S.D. Calif.); *In Re Irving Electrical Supply Co.*, 41 F. Supp. 16 (S.D. N.Y.). By this priority, potential creditors are encouraged to deal with a business that would—without such priority—be a poor credit risk, thus tending to assure the orderly administration of the estate and—particularly important in a Chapter XI proceeding—enhancing the possibility of rehabilitating the debtor. Cf. *Securities & Exchange Comm.* v. *U.S. Realty Co.*, 310 U.S. 434; *Nicholas* v. *United States*, 384 U.S. 678, 684–685, 687; H. Rep. No. 2320, 82d Cong., 2d Sess., pp. 9–10 (2 U.S.C. Cong. & Adm. News (1952) 1960, 1969–1970); S. Rep. No. 1954, 87th Cong., 2d Sess., pp. 5–6 (2 U.S.C. Cong. & Adm. News (1962) 2603, 2607–2608).

As the majority of the Third Circuit held, this rationale does not require giving the first priority of administrative expenses to a claim, such as petitioner's, which sounds wholly in tort. In no manner did the action of Knight's unsecured creditors in proposing an arrangement, and thus consenting to subordinate their claims to those who dealt with the debtor during the arrangement, induce petitioner to deal with Knight or in any way to act differently than it would have if those creditors had instead forced Knight into bankruptcy.

Moreover, the objective of Chapter XI—to encourage the use of arrangements when there is a chance of rehabilitating the debtor—requires the result below.

An arrangement may be proposed by general unsecured creditors; but it cannot be implemented without the consent and forbearance of governments having tax claims and of other statutory priority creditors. That consent is premised on the predictability of the nature and extent of the administrative expenses that will be incurred and attain first priority, during the arrangement. Were tort claims arising during administration given priority equal to the ordinary and expected commercial expenses of running the business during the arrangement, statutory priority creditors would be more likely to exercise their rights, Bankruptcy Act Sections 64a and 337(2), 11 U.S.C., Secs. 104(a) and 737, to insist that either they be paid in full before the arrangement proceeds or that the debtor be forced into bankruptcy.

The result is equally in accord with the congressional intent that may be inferred from the history—however slight—of legislation dealing with the provability of tort claims in bankruptcy. "Historically, bankruptcy laws, both in England and in this country, have dealt primarily and particularly with the concerns of traders", with the result that tort claims could not be proved—and could not be discharged—in bankruptcy. *Schall* v. *Camors,* 251 U.S. 239, 250. Aside from claims reduced to judgment, Congress has provided but one exception—in Section 63a(7) of the Bankruptcy Act 11 U.S.C. 103(a)(7), which allows proof in bankruptcy of negligence claims upon which an action has been instituted and is pending when the bankruptcy petition is filed. No other tort

claims based solely on tortious conduct may be presented to the bankruptcy court. Bankruptcy Act Section 63a, 11 U.S.C. 103; 3 Collier on *Bankruptcy* (Fourteenth ed., 1964), pars. 63.25 and 63.29. Thus, were the priority of an administrative expense given petitioner's claim, one which Congress has generally not allowed to be provable nor dischargeable in bankruptcy, petitioner then would be given a priority ahead of statutory priority claims such as the federal tax claims here in issue, and equal to—and therefore in dilution of—the priority granted to the claims of commercial suppliers who have dealt with the trustees in reliance upon the usual priority rule.

In *Schall* v. *Camors, supra,* this Court held that a tort claim resulting from the bankrupt's fraud was not provable in bankruptcy. There is no greater reason here than in *Schall* "to depart so widely from the precedents as to include mere tort claims," 251 U.S. at 250, among those chargeable against the estate.

2. The decision below is not in conflict with either *Vass* v. *Conron Bros.*, 59 F. 2d 969 (C.A. 2), or *In re Progress Lektro Shave Corp.,* 35 F. Supp. 915 (D. Conn.). *Vass* involved a State court suit by a lessee of a cold storage plant for damages resulting from the bankrupt lessor's failure to refrigerate the building. Although the suit contained an alternative count based on negligence, Judge Learned Hand found "this adds nothing." 59 F. 2d at 970. *In re Progress Lektro Shave Corp.* was a patent infringement suit, where the failure to allow recovery would have resulted in

unjust enrichment of the bankrupt estate. *Cf. American A. & B. Coal Corp.* v. *Leonardo Arrivabene S.A.*, 280 F. 2d 119, 125–126 (C.A. 2); 3 Collier on *Bankruptcy* (Fourteenth ed., 1964), Par. 6325.

In *Schall* v. *Camors, supra,* this Court explicitly anticipated cases such as *Vass* "[w]here the tortious act constitutes at the same time a breach of contract," and cases such as *In re Progress Lektro* "where * * * the tort feasor obtains something of value for which an equivalent price ought to be paid, even if the tort as such be forgiven, there may be a provable claim *quasi ex contractu.*" 251 U.S. at 251. As this Court recognized, such cases raise "a different question" than one such as the present suit involving "a mere tort * * *." *Id.*

3. Petitioner has not, as it claims, been deprived of the right to sue the trustee provided by 28 U.S.C. 959, or of its property without due process. It may, under 28 U.S.C. 959 bring suit, as has an insurance company subrogated to another [redacted] claimant[5] and obtain a judgment if it proves its allegations. To be sure, if Knight's affairs are wound up and the corporation liquidated as a result of the pending bankruptcy proceedings, petitioner will be unable to collect on whatever judgment it may secure. But this would put petitioner in no different circumstance than any claimant against a judgment-proof tort-feasor. Nor does it place petitioner in any worse position than a claimant injured by a tort committed be-

[5] *Home Ins. Co.* v. *Brown*, E.D. Pa., No. 39079, filed October 31, 1965.

fore an arrangement or bankruptcy proceedings whose claim is barred because it is not based on negligence, *Schall* v. *Camors, supra,* or was not filed in the time required by Section 63a(7).

Not all claims in an insolvency situation can be satisfied in full. Congress in the bankruptcy statutes necessarily determined the provability and priority of claims against the estate in the light of all relevant public policy and equitable considerations.[6] Nothing in the Constitution forbids the congressional decision to continue, with the limited exceptions provided in Section 63a, the traditional rule which forbids either payment or discharge of tort claims in bankruptcy. See *Kuehner* v. *Irving Trust Co.,* 299 U.S. 445; *Wright* v. *Union Central Ins. Co.,* 304 U.S. 502; cf. *Goldblatt* v. *Hempstead,* 369 U.S. 590.[7]

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[6] Petitioner's contention that the result below would deter the receivers from carrying insurance (Pet. 5) ignores the fact that the risk of fire loss is one that the owners of a building may insure against more readily than the owners of an adjacent or neighboring building. Moreover, the commercial creditors over whom petitioner seeks priority can in no circumstances insure their claims.

[7] It is by no means as clear as petitioner suggests that it would have been unable to share in the estate as a general unsecured creditor. The only reason for finding that if petitioner filed suit before the adjudication in bankruptcy, it would not qualify for such a share, is Section 378(2) of the Bankruptcy Act, 11 U.S.C. 778(2), which provides that when bankruptcy follows an arrangement, the bankruptcy "proceeding shall be conducted, *so far as possible,* in the same manner and with like effect as if a voluntary petition * * * had been filed and * * * adjudication * * * entered on the [redacted] day when the petition [for the arrangement] * * * was filed * * *." (Emphasis supplied.) Nothing in the statute would bar a holding that it is not "possible"

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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to give effect to the earlier date in order to allow a claim for a tort committed during the arrangement and resulting in the filing of a suit before the bankruptcy.

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